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No. 87-1160

IN THE

Supreme Court of the United States

OCTOBER TERM, 1987

DUQUESNE LIGHT COMPANY
AND
PENNSYLVANIA POWER COMPANY,
Appellants,

v.

DAVID M. BARASCH,
CONSUMER ADVOCATE, *et al.*,
Appellees.

On Appeal from the Supreme Court of Pennsylvania

BRIEF OF PENNSYLVANIA ELECTRIC ASSOCIATION AS AMICUS CURIAE IN SUPPORT OF APPELLANTS

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QUESTION PRESENTED

Whether a state may constitutionally deny a regulated utility any compensation for prudent expenditures that the utility is statutorily required to incur for the benefit of ratepayers?

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INTERESTS OF AMICUS CURIAE[1]

The Pennsylvania Electric Association is a trade association of electric utilities. Its members are eleven investor-owned utilities that provide electric service to the public in Pennsylvania.[2] These companies supply approximately 98 percent of the electricity consumed in the state and provide service to approximately 95 percent of the state's residential, commercial, and industrial customers.

[1]Each of the parties to this appeal has consented to the filing of this *amicus curiae* brief. These consents have been filed with the Court.

[2]The members of the Pennsylvania Electric Association are: Citizens' Electric Co., Duquesne Light Co., Metropolitan Edison Co., Pennsylvania Electric Co., Pennsylvania Power & Light Co., Pennsylvania Power Co., Philadelphia Electric Co., Pike County Light & Power Co., UGI Corporation, Wellsboro Electric Co., and West Penn Power Co.

Each member company of the *amicus* association is engaged in transmitting or distributing electricity within designated franchised service areas in the state. Each is regulated by the Pennsylvania Public Utility Commission, which sets the rates for each company. Each company is further under a statutory duty to provide service to any customer in its service area and to construct or obtain generating capacity that is adequate to serve present, and anticipated future, demand. To carry out these statutory duties, each of these utilities must be afforded an opportunity to charge rates that recover all its reasonable expenses as well as provide a reasonable return on investment.

Amicus has a direct and substantial interest in this case. The Pennsylvania Supreme Court has held that a utility may constitutionally be denied recovery of and on a $50 million investment that was reasonably made to carry out a statutory duty, whenever, with the benefit of hindsight, the investment is deemed not to have been "used and useful." The court so held, despite the fact that the electric utilities were also denied any opportunity to be compensated for the risks that such prudent expenditures would be disallowed. The net result is that Pennsylvania has assured that utility investors will not be fairly compensated for their reasonable costs of conducting business, including capital costs. Unless reversed, the Pennsylvania Supreme Court's decision will jeopardize the ability of Pennsylvania utilities to attract capital and provide adequate service to the public.

STATEMENT OF FACTS

A single "stubborn fact" of finance controls this case. Pennsylvania has imposed a duty on electric utilities to make multimillion dollar investments for the benefit of ratepayers, and then denied those utilities—and the investors who own them—any opportunity to be compensated for the costs of complying with that duty.

Electric utilities in Pennsylvania are under statutory obligations to serve any customer within their service areas at state-regulated rates. 66 Pa.C.S. § 1501. To carry out this duty, electric utilities must assure that they will have adequate generating capacity to meet the annual "peak" demands of customers, plus a reasonable reserve margin. Otherwise, there will be "brownouts," "blackouts," and customer service curtailments. When faced with the possibility or probability that future growth in demand may create shortages, Pennsylvania electric utilities do *not* have the option available to firms in unregulated markets. They may not decline to make investments required to meet the anticipated demand on the ground that the likely rewards do not justify the risks. They have the statutory obligation to make affirmative efforts to construct or otherwise obtain sufficient generating capacity.

Pennsylvania made this statutory duty explicit in 1972 and 1973. The Pennsylvania Public Utility Commission was concerned that Pennsylvania electric utilities were not constructing the new plants that would be needed under the then-prevailing forecasts for future growth in customer demand. Those forecasts predicted that demand would continue to grow by five to seven percent annually, as it had since World War II. J.S. App. 16h. The commission ordered Pennsylvania utilities to make "immediate preparations . . . to increase installed capacity until a reliable reserve of 20% above forecasted loads was reached." *Investigation of the Need for Additional Electric Generating and Transmission Facilities*, 46 Pa. P.U.C. 23, 24 (1972).

To carry out their state law duties, Pennsylvania utilities had to act on the basis of forecasts relating to the distant future. This is so because a new generating facility has to be planned 10 to 15 years in advance and requires projections of long-term load growth.[3] In consequence, the only certainty when such projec-

[3]It takes seven to nine years to plan and build a coal fired plant, and ten to twelve years for a nuclear plant. Here, it is undisputed that nuclear power represented the lowest cost alternative for the Pennsylvania utilities when the planning decisions were made. J.S. App. 17h.

tions are made is that they will often turn out to be wrong. For this reason, construction and capacity planning decisions of electric utilities are subject to constant adjustments.

The Pennsylvania Public Utility Commission found—and it is undisputed—that the expenditures that appellants made to carry out the duties imposed by state law were eminently reasonable. Indeed, it would have been imprudent—and threatened ratepayer interests—if the utilities had failed to make these expenditures. In planning the CAPCO nuclear plants, the Pennsylvania utilities acted on the basis of the best information available. They chose what was indisputably the least cost alternative at that time. It was only because of unforeseen, and unforeseeable, changes in circumstances that the plants subsequently appeared to be unnecessary, and that it became prudent to cancel the plants in 1980. J.S. App. 16h-19h.

Moreover, no actual construction ever began. Work on the plant was limited to the preliminary engineering and siting studies that must occur before actual construction can begin. These expenditures put Pennsylvania utilities in a position in which they could have proceeded with the construction of the new plants in 1980 if the plants continued to appear needed. Because intervening events reduced the need for the plants, they could be—and were—prudently cancelled before any construction occurred. J.S. App. 17h-19h. All agree that the engineering and siting costs were prudently incurred, and that the plants were prudently cancelled. *Id.*

Despite these facts, Pennsylvania has now blocked its utilities from receiving any compensation for the over $50 million that appellants reasonably expended on the four CAPCO plants.

The two Pennsylvania utilities were in no way compensated, directly or indirectly, for these expenditures over the eight-year period in which the expenditures were made. The utilities were not allowed to treat the engineering and siting studies as current

"expenses" that would be recovered as outlays were made over this period. Instead, the utilities were required to treat these expenditures as "investments" by "capitalizing" them and recording them in a separate account. The net effect was to exclude these amounts from the utilities' rates during this period and to defer their recovery to a future date. Between 1972 and 1980, rates were set as if the expenditures had never been made between 1972 and 1980.

In this case, the Pennsylvania Supreme Court has construed an intervening Pennsylvania statute to require that present and future rates also be set as if the $50 million had never been spent. It held that expenditures that are not deemed to be currently "used and useful" may not be recovered, regardless of how prudent they were at the time they were made and regardless of any other considerations. Under the court's authoritative construction of the Pennsylvania statute, these expenditures "shall not, in any way whatsoever, be included in the rates charged." J.S. App. 14a. The utilities may not receive a return "of and on" their investment by amortizing it over a period of years and receiving a return on the unamortized balance each year. The utilities may not even receive a return "of" their investment by amortizing it, but receiving no return on the unamortized balance. Nor may these amounts be recovered through any other mechanism.

In contrast, Pennsylvania has sharply limited the ability of utilities to benefit from investments and expenditures that are deemed "used and useful." Under Pennsylvania law, a utility can be, and is, limited to recovery of reasonable out-of-pocket expenses and a return on the net original cost (original cost less depreciation) of the utility's investment—and has no judicially enforceable right to obtain any greater return.[4] Thus, the "rate

[4]The Pennsylvania Supreme Court has held that the Pennsylvania statutes in effect when the rate orders were entered do not entitle utilities to rates that "go beyond [allowing a fair return on the] original cost" of the utility's property, and that there are no statutory or judicially en-

(Footnote continued on next page)

bases" of the two Pennsylvania utilities involved in this case were determined on the basis of each's net original cost. See J.S. App. 3c (adopting "original cost measure of value" to determine utility rate base); 5e (same).

SUMMARY OF ARGUMENT

The Pennsylvania statutory scheme is unconstitutional, both on its face and as applied to the two utilities who are the appellants in this case. Pennsylvania here required its utilities to spend millions of dollars to plan new generating facilities for the benefit of the public and then denied the utilities any form of compensation for prudent expenditures made to carry out this statutory duty. This epitomizes the conduct that it is a *per se* violation of the Fifth and Fourteenth Amendments. See *Armstrong* v. *United States*, 364 U.S. 40, 49 (1960).

Pennsylvania reached this unconstitutional result by confusing two separate and distinct methods of setting utility rates. Under the "fair value"/"used and useful" standard of *Smyth* v. *Ames*, 169 U.S. 466 (1898), utilities are denied any return on investments that are not "used and useful," but are fully compensated for the risk of such disallowances because they are entitled to supernormal returns on other investments. Under the "prudent investment" test of Justice Brandeis, utilities receive a return on

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forceable standards under which a method more favorable to the utility could be required. *Pennsylvania Public Utility Commission* v. *Pennsylvania Gas & Water Co.*, 492 Pa. 326, 424 A.2d 1213, 1221 & 1219-22 (1980), *cert. denied*, 454 U.S. 824 (1981). The utility commission thus lawfully refuses to consider any other method of valuation. *See Barasch* v. *Pennsylvania Public Utility Commission*, 505 Pa. 606, 482 A.2d 1274 (1984), *rev'g, Pennsylvania Gas & Water Co.* v. *Pennsylvania Public Utility Commission*, 72 Pa. Commw. 331, 456 A.2d 1126 (1983).

In 1984, Pennsylvania codified this rule by enacting a statute that provides that the valuation of utility property "shall be the original cost of the property when first devoted to the public service less the applicable accrued depreciation." 66 Pa.C.S. § 1311(b); J.S. App. 201.

all prudent investments, whether or not they are "used and useful," and the utilities cannot receive a supernormal return on any investment, no matter how beneficial. See *State of Missouri ex rel. Southwestern Bell Telephone Co.* v. *Public Service Commission*, 262 U.S. 276, 289-312 (1923) (Brandeis, J., concurring). See *Federal Power Commission* v. *Hope Natural Gas Co.*, 320 U.S. 591 (1944).

Here, Pennsylvania selectively adopted only those elements of each test that disadvantage utilities. Pennsylvania limited utilities to the minimal allowable return on "used and useful" investments (under a prudent investment standard) and denied any return on other prudent investments made for the benefit of ratepayers (under a "fair value" standard). Because it is inevitable that some prudent investments will be deemed not to be "used and useful" —and excluded—the Pennsylvania scheme assures that utilities are not compensated for expenditures, and risks, they are statutorily required to incur. This mixing of distinct methods to guarantee a shortfall is *per se* unconstitutional. See *West Ohio Gas Co.* v. *Public Utilities Commission*, 294 U.S. 63 (1935).

The Pennsylvania Supreme Court's decision is one of many recent state supreme court decisions that rest on the belief that the Federal Constitution authorizes an amorphous "balancing" of a generalized (and boundless) consumer interest in lower rates against an investor interest in having a fair opportunity to recover all prudent costs. That is not, and cannot be, the law.

Amicus submits that there is one approach that will now secure constitutional values and protect this Court's docket: adopt Justice Brandeis's prudent investment test as the constitutional benchmark. The Court should make it explicit that a state may not depart from this approach, unless the state affirmatively demonstrates that it has fairly compensated utility investors for the risk that prudent investments will be disallowed by permitting above-cost returns on other investments. Correlatively, the Court

should reiterate that there is no generalized consumer interest in lower rates that can justify denying utilities an opportunity to recover all amounts prudently invested for the benefit of ratepayers.

ARGUMENT

This *amicus curiae* brief makes two principal points. First, under any view of this Court's prior decisions, the Pennsylvania statutory scheme is unconstitutional, both on its face and as applied to the two appellant utilities. As authoritatively construed by the Pennsylvania Supreme Court, the Pennsylvania statutes deny the two Pennsylvania utilities any possibility of being fairly compensated for expenditures, and risks, that the utilities were under a state-created *duty* to incur for the benefit of the public as a whole. This is a *per se* violation of the Fifth and Fourteenth Amendments. In any event, Pennsylvania's own enactments make it explicit that there is no "consumer interest" or other state interest that could possibly justify this interference with the property rights of utility investors.

Second, the Pennsylvania Supreme Court's decision in this case is a product of the confusion that arises from the coexistence of two separate and distinct means of setting utility rates, each of which is constitutionally permissible when consistently applied. The first is the "fair [market] value"/"used and useful" standard of *Smyth* v. *Ames*, 169 U.S. 466 (1898), and its progeny. It is sound as a matter of theory, but has proven to be impractical of fair and consistent application unless market value is equated with reproduction cost, or some proxy for it. The second is the prudent investment test of Justice Brandeis,[5] which is the foundation of *Federal Power Commission* v. *Hope Natural Gas Co.*,

[5] *State of Missouri ex rel. Southwestern Bell Telephone Co.* v. *Public Service Commission*, 262 U.S. 276, 289-312 (1923) (Brandeis, J., concurring).

320 U.S. 591 (1944), and its progeny. This test can be readily applied to protect all legitimate investor and consumer interests.

In *amicus's* view, both this case and the experience of the past decade demonstrate that there is now only one way to implement the values of the Fourteenth Amendment in this sensitive and increasingly contentious area: adopt Justice Brandeis's standard as the constitutional benchmark. The Court should make it explicit that utilities are entitled to a fair opportunity to recover all reasonable expenses and to earn a return of, and on, all prudent investment. States should be entitled to depart from the strict prudent investment standard only if they *affirmatively* demonstrate that some other mechanism has been adopted that adequately compensates utility investors for the risks and expenditures they are required to incur. Correlatively, the Court should reiterate that a generalized "consumer interest" in lower rates is not itself sufficient justification for denying a utility an opportunity to earn a return of and on any investment found to be prudent.

I. The Pennsylvania Statutes Violate The Fifth And Fourteenth Amendments.

A. Pennsylvania's Statutory Scheme Is A Per Se Violation Of The Federal Constitution.

The provisions of the Fifth and Fourteenth Amendments that protect private property are "designed to bar Government from forcing some people alone to bear public burdens which, in all fairness and justice, should be borne by the public as a whole." *Armstrong* v. *United States*, 364 U.S. 40, 49 (1960). The Pennsylvania statutes are a stark, clear violation of these provisions. Pennsylvania has imposed a statutory duty on utilities to make massive expenditures for the benefit of the public as whole. Pennsylvania has now adopted rules that assure that even the most prudent of such expenditures will not be recovered from the public "in any way whatsoever" if—as will inevitably sometimes be

the case—the investments can be deemed not to be "used and useful" on the basis of hindsight.

The inevitable "end result" of the Pennsylvania scheme is that Pennsylvania utilities will experience multi-million dollar shortfalls. By simultaneously limiting each utility to a return of and on the original cost of its "used and useful" investments and denying the utility any return of (or on) other prudent investments, the state has guaranteed that the two utilities—and the investors who own them— may not recover their original prudent investment. Here, a $100 million shortfall results solely from the utilities' compliance with a statutory duty imposed for the benefit of the public.[6]

The Pennsylvania scheme would be invalid as applied to any person. It is starkly invalid as applied to a regulated utility.

1. All Firms Must Have The Opportunity To Be Compensated For Carrying Out Statutory Duties That Benefit The Public.

The unconstitutionality of the statutory scheme is vividly demonstrated by the facts of this case. The expenditures were made to carry out a state-created duty. The Pennsylvania utilities did not have the options available to unregulated firms. They were not free to decide that the probable returns from the investments in the CAPCO plants did not justify the risks of proceeding. They had an obligation to make "immediate preparations" to build the plants, and all agree that the utilities acted with the utmost prudence in fulfilling that obligation.

[6]The two utilities' capitalized expenditures exceeded $50 million on the day the plants were cancelled. If the utilities were to recover the present value of that $50 million over ten years, they would have to receive some 100 million in nominal dollars over the ten year period. See J.S. App. 19h-20h. Whatever the method chosen, the utilities will not be "made whole" in an economic sense unless they receive the present value of the $50 million figure.

Further, these "immediate preparations" were ordered precisely because, in the state's judgment, they would confer real and tangible benefits on Pennsylvania consumers, whether or not the plants ended up being built. The engineering and siting expenditures were necessary prerequisites to the actual construction of the new generating facilities that would have been essential if the then-prevailing forecasts of future consumer demand had turned out to be correct. The expenditures were thus akin to an insurance policy purchased for the benefit of ratepayers. The expenditures put the Pennsylvania utilities in a position in which they could have built the plants and met the consumer demand if the forecasts had materialized. The expenditures assured consumers that future demand would be met.

What Pennsylvania has done here is no different from ordering a utility to buy fire insurance for the benefit of ratepayers and thereafter blocking the utility from recovering the premiums on the ground that no fire occurred, and the insurance therefore was not really needed.

This would be a violation of the Fourteenth Amendment even if appellants were not utilities. It is elementary that a state may not constitutionally impose a statutory duty to engage in conduct for the benefit of the public, while prohibiting a property owner from being fairly compensated for the resulting costs. In *Pennsylvania Central Transportation Co.* v. *City of New York*, 438 U.S. 104 (1978), for example, the state landmark law had imposed a statutory duty on the property owner to keep the facade of a landmark building "in good repair." All nine members of the Court agreed that there would have been an unconstitutional "taking" of property if the state were preventing the landowner from recovering the expenses resulting from this obligation, plus a "reasonable return" on investment in the parcel. *Id.* at 120 n.21 & 121 n.23; *accord id.* at 146-47 & n.9 (Rehnquist, J., dissenting on other grounds).

This principle applies with special force to regulated utilities.

2. A Utility May Not Be Denied A Return Of And On Its Prudent Investment Unless It Is Otherwise Compensated For The Risks And Expenditures That It Incurs.

The Pennsylvania Supreme Court's holding rests on a misapprehension of settled law. The court conceded, as it must, that the Federal Constitution would have required Pennsylvania to allow the utilities to earn a return of, and on, the amounts prudently invested in the CAPCO plants if they had been completed and in fact used to provide service to the public. However, it held that the fact that the plants were not built—and are thus not "used and useful"—permits the state to deny any recovery of, or on, expenditures that the utilities were required to make. This holding confuses two distinct methods of protecting the constitutional rights of utility investors: the "fair value"/"used and useful" standard of *Smyth* v. *Ames*, and the prudent investment standard of Justice Brandeis. By selectively adopting only those elements of each test that disadvantage utilities, Pennsylvania has committed a *per se* violation of the Federal Constitution.

The *Smyth* and Brandeis approaches represent two separate and distinct means of implementing the central value protected by the Fifth and Fourteenth Amendments. Each recognizes the legitimacy of the state's interest in regulating public utilities and ordering the devotion of private property to public service. *See Smyth* v. *Ames*, 169 U.S. 466, 546 (1898). The natural monopoly character of aspects of utility businesses creates the possibility of monopolistic pricing and other exploitative practices. Maximum price regulation and the obligation to serve all persons on nondiscriminatory terms can prevent those practices—and operate as a surrogate for the operation of a competitive marketplace.

At the same time, the use of elected or politically-appointed bodies to set the prices at which private property will be used by the public inherently creates the serious possibility that utility investors will be unfairly singled out to bear burdens that the ratepaying public should bear, contrary to the central purpose of

the Fifth and Fourteenth Amendments. Thus, each line of decisions holds that restrictions on utilities must be accompanied by corresponding assurances that the utility will be guaranteed an opportunity to be fairly compensated for the duties, and risks, that it is required to incur. The risks and opportunities for rewards must balance out. That is the regulatory compact.

Smyth v. *Ames*, and its progeny, prescribed one means of striking this constitutional balance. The Court's opinion, authored by the first Justice Harlan, analogized the submission to public utility regulation to a taking of property by eminent domain, and required that rates be set to provide a return of the "fair [market] value" of the physical assets deemed "taken:" that is, the plant that was "used and useful" in the enterprise. 169 U.S. at 546-47. In theory, *Smyth's* "fair value" standard mimics the operation of a competitive market. To the extent utilities' investments in plants are good ones (because they produce benefits in excess of their costs), the utility is "rewarded" with an opportunity to earn an "above-cost" return: that is, a fair return on the "market value" of the plant. To the extent utilities' investments turn out to be bad ones (because the plants are cancelled or abandoned before being fully depreciated or because they were acquired or built at inflated prices), the utilities suffer because a return on the plants' "fair [market] value" is no return, or a below-cost return. Under *Smyth*, the risks and opportunities for rewards are balanced, much as they are in a competitive market.

Whatever its theoretical appeal, the *Smyth* test proved impractical of fair and consistent administration.[7] This was largely be-

[7]A "fair value" test does have one area of easy application: where competition from new technologies (or utility mismanagement) had created a situation where a utility could not recover the original costs of its investment, much less the cost of reproduction, even if its rates were deregulated altogether. In that circumstance, a fair market value could be computed by capitalizing future earnings (or determining salvage value) and setting rates accordingly. The Constitution requires no great-

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cause any attempt by a regulator to establish a "fair [market] value" for utility plants is inherently a circular one.[8] As Justice Brandeis demonstrated, "almost any result may be justified" under the *Smyth* v. *Ames* "test."[9] In practical effect, the only way to prevent undercompensating investors was to measure "fair value" based on the reproduction cost of the plants or on some proxy for reproduction cost that can be readily calculated, such as the original cost adjusted for inflation (trended original cost). This Court's opinions thus increasingly required these valuation methods during the 1910s and 1920s.[10] But with high inflation, this interpretation of *Smyth* led to prescriptions of rates that—while

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er return in such instances, for it is market forces, *not* the state, that prevents a greater recovery. *See Market Street Railway Co.* v. *Railroad Commission of California*, 324 U.S. 548, 566-67 (1945). However, where, as here, the utilities' services are very valuable, and it is state regulation alone that would prevent a utility from recovering all its costs, *Smyth* proved impractical.

[8]As Justice Brandeis explained, a "vicious circle" is inevitable:

> "It is impossible to find an exchange value for a utility, since utilities, unlike merchandise or land, are not commonly bought and sold in the market. Nor can the present value of the utility be determined by capitalizing its net earnings, since the earnings are determined, in large measure, by the rate which the company will be permitted to charge; and, thus, the vicious circle would be encountered."

State of Missouri ex rel. Southwestern Bell Telephone Co. v. *Public Service Commission*, 262 U.S. 276, 292 (1923) (Brandeis, J., concurring). *Accord Federal Power Commission* v. *Hope Natural Gas Co.*, 320 U.S. 591, 601 (1944).

[9]*State of Missouri ex rel. Southwestern Bell Telephone Co.* v. *Public Service Commission*, 262 U.S. at 298 (Brandeis, J., concurring).

[10]*See, e.g., McCardle* v. *Indianapolis Water Co.*, 272 U.S. 400, 410 (1926); *State of Missouri ex rel. Southwestern Bell Telephone Co.* v. *Public Service Commission*, 262 U.S. at 287-88; *id.* at 289-312 (Brandeis, J., concurring); *Bluefield Water Works & Improvement Co.* v. *Public Service Commission*, 262 U.S. 679, 689 (1923); *Minnesota Rate Cases*, 230 U.S. 352, 434, 454 (1913); *Willcox* v. *Consolidated Gas Co.*, 212 U.S. 19, 41, 52 (1909).

eminently sound as a matter of economics and preferable as a matter of policy[11]—became difficult to defend as constitutional requirements.

The shortcomings of *Smyth* v. *Ames* led Justice Brandeis to develop an alternative approach, which he advocated as the constitutional minimum. He accepted the *Smyth* eminent domain analogy, but concluded that what was "taken" by public utility regulation is not specific physical assets that are to be individually valued, but the capital prudently devoted to the public utility enterprise by the utilities' owners—investors. *State of Missouri ex rel. Southwestern Bell Telephone Company* v. *Public Service Commission*, 262 U.S. at 290 (Brandeis, J., concurring). "The thing devoted by the investor to the public use is not specific property, tangible and intangible, but capital embarked in the enterprise." *Id.* Justice Brandeis urged that "[t]he compensation which the Constitution guarantees an opportunity to earn is the reasonable cost of conducting the business," including the costs of capital that are recovered by allowing a reasonable return on the utility's investment. *Id.* at 291.

> "Cost includes not only operating expenses, but also capital charges. Capital charges cover the allowance, by way of interest, for the use of the capital, whatever the nature of the security issued therefor; the allowance for risk incurred; and enough more to attract capital. The reasonable rate to be prescribed by a commission may allow an efficiently managed utility much more. But a rate is constitutionally compensatory, if it allows to the utility the opportunity to earn the cost of the service as thus defined." *Id.*

Justice Brandeis stated that there is only one limitation that states may constitutionally impose on a utility's opportunity to earn adequate revenues on its actual investment: exclusion of imprudent investment or expenditures. He stated that "the term [prudence is to be] applied for the purpose of excluding what

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[11]*E.g.*, A. Kahn, *The Economics of Regulation*, Vol. I, 109ff (1970).

might be found to be dishonest or obviously wasteful or imprudent expenditures." *Id.* at 289 n.1.

Under Justice Brandeis's net prudent investment test, the historic concept of "used and useful" is irrelevant.[12] The utility must be guaranteed the opportunity to recover all prudent expenses, and earn a return of, and on, all amounts prudently invested in its utility business, irrespective of whether individual investments are deemed necessary or beneficial in hindsight. When prudent investment is the standard, the net result is that utilities have no opportunities for "rewards" (in the form of above-cost returns), because all that is returned is the prudent investment, including capital costs. But the utilities also incur fewer risks. Although a utility always bears the risk that ratepayers will not be willing to pay enough for utility service to cover its cost (see pp. 13-14 n.7, *supra*), the prudent investment test assures the utility the opportunity to recover any investment not found imprudent. This test thus also strikes a constitutional balance.

Justice Brandeis's opinions formed the foundation for *Federal Power Commission* v. *Hope Natural Gas Co.*, 320 U.S. 591 (1944). *Hope Natural Gas* both adopted the Brandeis view that "fair value" ratemaking is not constitutionally required and established that the prudent investment test is constitutionally permissible. At the same time, *Hope* held that the Federal Constitution does not require "the use of any single formula or combination of formulae in determining rates." 320 U.S. at 602. This holding reflects the reality that either the prudent investment test of Justice Brandeis, the fair value/used and useful test of *Smyth*, or any other approach that fairly balances risks and rewards can reasonably compensate investors for the duties and risks that they incur,

[12]*State of Missouri ex rel. Southwestern Bell Telephone Co.* v. *Public Service Commission*, 262 U.S. at 290-91 (Brandeis, J., concurring); *Accord Jersey Central Power & Light Co.* v. *FERC*, 810 F.2d 1168, 1175 (D.C. Cir. 1987) (en banc) (Bork, J.) ("with the demise of 'fair value,' 'used and useful' ceased to have any constitutional significance"); *Washington Gas & Light Co.* v. *Baker*, 188 F.2d 11, 19 (D.C. Cir. 1950) (Bazelon, J.), *cert. denied*, 340 U.S. 952 (1951) (same).

and prevent unconstitutional deprivations of property.[13] The judicial role is to assure that the "end result" will be constitutional under whatever method is employed.

Against this background, the Pennsylvania statutory scheme, as construed by the Pennsylvania Supreme Court, is invalid both on its face and as applied to the two appellants. Because Pennsylvania selectively adopts different elements of two distinct methods, the Pennsylvania scheme is incapable of producing a constitutionally permissible "end result."

West Ohio Gas Co. v. *Public Utilities Commission*, 294 U.S. 63 (1935), is controlling. There, the Court, in an opinion written by Justice Cardozo, held that once a constitutionally permissible method of ratemaking is adopted, it "must be made use of then consistently, and regardless of the consequences." *Id.* at 71. In *West Ohio Gas*, the state commission allocated a utility's costs on one basis in one Ohio city and on a different and inconsistent basis in a second Ohio city served by the same utility. The net result was that rates were reduced in both cities, and the utility was blocked from ever recovering 100% of its expenses. *Id.* at 69-71. That was held to be unconstitutional.

Pennsylvania has mandated the same principle of "heads the utility loses, tails the ratepayer wins." Pennsylvania applies a

[13]Any standard that fairly balances the benefits and burdens of regulation can satisfy constitutional standards. For example, another constitutional approach was suggested in a 1950 opinion for the Court of Appeals for the District of Columbia Circuit, written by Judge Bazelon. See *Washington Gas Light Co.* v. *Baker*, 188 F.2d 11, 15-22 (D.C. Cir. 1950), *cert. denied*, 340 U.S. 952 (1951). It stated that a state commission can constitutionally adopt a "sliding scale" test that retains some reliance on the historic concept of "used and useful" *if* the commission affirmatively compensated the utility for the risk the investment would be disallowed over the period in which it was made by, for example, proving it increased the authorized rate of return for this purpose. There, the court allowed a return of, and on, the investment in an abandoned plant that was not "used and useful" because the commission had not affirmatively provided such compensation. *Id.*

strict fair market value test to "unsuccessful" investments. At the same time, it applies a strict original cost test to successful ones and adopts no other mechanism to compensate utilities for the risks that prudent and statutorily-required expenditures will be disallowed. In short, Pennsylvania has assured that the "end result" of its rate orders can never be fair compensation. This is a *per se* violation of the Fourteenth Amendment.

The Pennsylvania utilities have a federal constitutional right to a recovery of, and on, the over $50 million investment that they prudently made to discharge a statutory duty to the public. During the period in which the investment was made—and thereafter —Pennsylvania did not compensate these (or other) Pennsylvania utilities for the risk that a full recovery of, and on, prudent expenditures would be disallowed even in part. That this order would unconditionally destroy the constitutionally legitimate expectations of the utility could not be clearer.[14]

B. There Is No "Consumer Interest" Or Other State Interest That Could Possibly Justify This Interference With The Property Rights Of Pennsylvania Utility Investors.

The foregoing establishes that the Pennsylvania statutory scheme is a *per se* violation of the Fourteenth Amendment. However, it is apparent, in any event, that there is no "state's interest in [this] regulation" that could justify this interference with property rights. *Keystone Bituminous Coal Association* v. *De*

[14]However, the Court need not decide whether the appellants are entitled to a full recovery of, and on, these investments, for appellants have not challenged the failure to allow a return on the unamortized portions of their $50 million investment and thereby to return this investment in real dollars. Appellants are defending a commission rate order that gives them only a return "of " their investment by amortizing $50 million over a ten year period. There is no basis whatsoever for even a suggestion that Pennsylvania compensated the utilities for the risk that this prudent $50 million investment would be disallowed in its entirety. Indeed, as explained below, Pennsylvania's own actions demonstrate that there is no state interest that could justify such an extraordinary result.

Benedictis, 107 S. Ct. 1232, 1244 (1987); see *Nolan* v. *California Coastal Commission*, 107 S. Ct. 3141, 3146-48 (1987).

The Pennsylvania Supreme Court appeared to rest its decision on the ground that the Federal Constitution allows deprivations of utility property based on some amorphous "balancing" of a generalized "consumer interest" in reduced rates against the investor interest—and that any statute that restrikes this balance is constitutional. That is not, and cannot be, the law.

To be sure, *Hope Natural Gas* recognized that there are "consumer interests" that can constitutionally justify some interference with full realization of the "investor interests"[15] and that reasonable rates can be produced through a "balancing of the investor and consumer interests." *Id.* at 603. However, because all investor interests were fully protected in *Hope*, the Court did not there define the "consumer interests" that are to be balanced. See *id.*

Subsequent decisions make it very clear that the only legitimate "consumer interests" that can be advanced are preventing the utility from recovering truly imprudent investments or recovering amounts *in excess of* those required fairly to compensate utilities

[15]*Hope Natural Gas Co.* recognizes constitutionally protected "investor interests" that are far broader than those that Justice Brandeis discussed; they include a market return of and on all capital, with no stated limitation to prudent investment (320 U.S. at 603):

> "[T]he investor interest has a legitimate concern with the financial integrity of the company whose rates are being regulated. From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock. Cf. *Chicago & Grand Trunk Ry. Co.* v. *Wellman*, 143 U.S. 339, 345-346. By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital."

and their investors for the duties and risks that they incur.[16] To hold that there is a generalized (and boundless) consumer interest in having lower and more affordable rates and that this interest justifies reducing rates below the levels that represent the constitutional minimums would sanction unconstitutional deprivations of property. See *Pennell* v. *City of San Jose*, 108 S. Ct. 849, 861-64 (1988) (Scalia, J., concurring in part and dissenting in part on other grounds).

However, the Court need not address that issue to decide this case. Pennsylvania's own actions demonstrate that there is no consumer interest, or other state interest, that can justify the interference that occurred. The decisive fact is that Pennsylvania, by statute, has now authorized the recovery of, but not on, investment in any plant that is cancelled after 1985. This statute vitiates any claim that there is a "consumer" or other sufficient state interest that is served by denying any and all recovery of prudently-incurred investments in cancelled plants.

As authoritatively construed by the Pennsylvania Supreme Court, Pennsylvania law is now as follows. A utility that prudently expended $100 million in planning a plant over the period from 1972 to 1986 is entitled to receive a return of the $100 million in its rates because it gets the benefit of the 1985 statute. In contrast, a utility that prudently expended $50 million in planning a plant

[16]*See, e.g., Federal Power Commission* v. *Memphis Light, Gas & Water Division*, 411 U.S. 458, 474 (1973) ("under *Hope Natural Gas* rates are 'just and reasonable' only if consumer interests are protected *and* if the financial health of the pipeline in our economic system remains strong") (emphasis added); *Colorado Interstate Gas Co.* v. *FPC*, 324 U.S. 581, 605 (1945) ("end result" test "is not a standard so vague and devoid of meaning as to render judicial review a perfunctory process. It is a standard of finance resting on stubborn facts"); *Permian Basin Area Rate Cases*, 390 U.S. 747, 792 (1968) (a court must assure itself that "the order may reasonably be expected to maintain financial integrity, attract necessary capital, *and* fairly compensate investors for the risks they have assumed, and yet provide appropriate protection to the relevant public interests, both existing and foreseeable") (emphasis added).

over the period from 1972 to 1980 does not receive a nickel of the $50 million because the 1985 statute is inapplicable. No one has—or could—identify any basis for this difference in treatment. The investor interest is identical in each case: to be made whole for statutorily-required expenditures. If the generalized "consumer interest" in "lower rates" is a valid one, it applies with *greater* force in the case of the $100 million investment that is allowed than in the $50 million investment that is excluded.

This Court's decisions under the Taking Clause establish that the "dispensation" that Pennsylvania extends to plants cancelled after 1985 forecloses any reliance on "consumer interests" to justify the restrictions at issue in this case. In this respect, the case is controlled by *Nollan* v. *California Coastal Commission*, 107 S. Ct. 3141, 3148 (1987). As in *Nollan*, what Pennsylvania has done is the "same as if [Pennsylvania] law forbade shouting fire in a crowded theater, but granted dispensations to those willing to contribute $100 to the state treasury." 107 S. Ct. at 3148. As in *Nollan*, the presence in this case of a "dispensation" that is wholly unrelated to and inconsistent with the purported statutory justification forecloses a decision that the state interest is sufficient to justify what would otherwise be a clearly unconstitutional taking of property.

II. The Court Should Adopt The Brandeis Prudent Investment Standard As The Constitutional Benchmark.

The Pennsylvania Supreme Court's decision in this case is one of many recent state court decisions that have seriously tested, if not transgressed, the constitutional prohibition against the taking of property without just compensation, and these and similar decisions are imposing increasing burdens on this Court's docket.[17] They all rest on a widespread misinterpretation of the

[17]*See, e.g., Kansas Gas & Electric Co.* v. *State Corp. Commission*, 239 Kan. 483, 720 P.2d 1063 (1986), *probable jurisdiction noted*, 107 S. Ct. 1281, *appeal dismissed under Rule 53*, 107 S. Ct. 3280 (1987); *Citizens*

(Footnote continued on following page)

Court's prior pronouncements, and, in particular, on the belief that the Federal Constitution authorizes an amorphous, ad hoc balancing of a boundless "consumer interest" in lower rates against the interest of utility investors in having a fair opportunity to recover all their costs. The confusion has even led the Federal Energy Regulatory Commission recently to assert that rate orders —and the criteria on which they are based—are unreviewable.[18] The Court disavowed that view over 40 years ago.[19]

The confusion persists precisely because there are several methods of ratemaking that, at least in theory, would fully protect the ultimate constitutional interest. See pp. 12-17, *supra.* The multiplicity of possible approaches has produced the same problem that led to Justice Brandeis's criticisms of the rule of *Smyth* v. *Ames*. See pp. 13-14, *supra*. Today, a state legislature, regulatory commission, or court can justify "almost any result" it wants to reach by selectively adopting different aspects of different approaches. That is what the Pennsylvania legislature and court have done here. Indeed, the problem today is far more serious than the one that Justice Brandeis faced because, whatever its

(Footnote continued from previous page)
Action Coalition of Indiana, Inc. v. *Northern Indiana Public Service Co.*, 485 N.E.2d 610 (Ind. 1985), *appeal dismissed and cert. denied*, 476 U.S. 1137 (1986); *Cleveland Electric Illuminating Co.* v. *Public Utilities Commission*, 4 Ohio St. 3d 107, 447 N.E.2d 746, *appeal dismissed*, 464 U.S. 802 (1983); *Cleveland Electric Illuminating Co.* v. *Public Utilities Commission*, No. 82-165 (Ohio, July 7, 1982), *appeal dismissed*, 459 U.S. 1094 (1983); *Office of Consumers' Counsel* v. *Public Utilities Commission*, 67 Ohio St. 2d 153, 423 N.E.2d 820 (1981), *appeal dismissed*, 455 U.S. 914 (1982); *see also Petition of Public Service Commission of New Hampshire*, No. 87-311 (N.H. Jan. 26, 1988); *Toledo Edison Co.* v. *Public Utilities Commission*, 12 Ohio St. 3d 143, 465 N.E.2d 886 (1984).

[18]See *Jersey Central Power & Light Co.* v. *FERC*, 810 F.2d 1168, 1174 (D.C. Cir. 1987) (en banc) (quoting one FERC submission).

[19]*Colorado Interstate Gas Co.* v. *FPC*, 324 U.S. 581, 605 (1945) ("end result" test "is not a standard so vague and devoid of meaning as to render judicial review a perfunctory process. It is a standard of finance resting on stubborn facts.")

other deficiencies, *Smyth* v. *Ames* was generally implemented to err on the side of protecting constitutional rights. See p. 14 & n.10, *supra*.

Against this background, *amicus* submits that the appropriate approach, both to secure constitutional values and to protect this Court's docket from the burden of reviewing the details of a plethora of rate decisions, is to adopt the prudent investment test of Justice Brandeis as the constitutional benchmark. That test protects investor interests by providing for a return on actual prudent net investment and recovery of all prudent expenses. It also protects all legitimate consumer interests by authorizing the exclusion of wasteful and imprudent expenses.

By making Justice Brandeis's approach the benchmark, the Court would not foreclose individual states from adopting different approaches. However, the Court would make it clear that a state cannot disallow all, or some, of a prudent investment, unless it first affirmatively demonstrates that some other mechanism has been provided to compensate utility investors for that risk: by authorizing above-cost return on other investments or otherwise. See p. 17 n. 13, *supra.*

At the same time, the Court need not now foreclose the possibility that there are, or could be, other state interests that would justify denying utility investors a fair return. However, it should reject any notion that a generalized "consumer interest" in lower, and more affordable, rates can be such a factor. Consumers have a legitimate interest in paying rates that exclude truly wasteful and imprudent expenditures. They also have an interest—which is the foundation for rate regulation of natural monopolies—in preventing monopoly pricing and prohibiting discriminatory and exploitative practices. But when these interests are safeguarded—as they are under the prudent investment test or any constitutional surrogate—further rate reductions in the name of some amorphous "consumer interest" is a taking of investor property. See pp. 19-20, *supra*.

CONCLUSION

For the reasons stated, the judgment of the Pennsylvania Supreme Court should be reversed.

Respectfully submitted,

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